UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Investigation of Terms and Conditions	**)**	**Docket No. EL01-118-000**
of Public Utility Market-Based	**)**	
Rate Authorizations	**)**	

REPLY COMMENTS OF THE STATE OF MICHIGAN AND MICHIGAN PUBLIC SERVICE COMMISSION

On January 7, 2002, the State of Michigan and the Michigan Public Service Commission (Jointly "Michigan") filed initial comments in this proceeding jointly with the New England Conference of Public Utilities Commissioners, supporting, with clarifications, the Commission's proposal to amend the terms of market-based rate schedules. A number of parties have filed comments objecting to the Commission's order or recommending substantial modifications. Pursuant to the Commission's notice and order issued November 20, 2001 ("November 20 Order"),[1] Michigan hereby submits its reply comments addressing those objections.

Objections to the Commission's November 20 Order fell largely into three categories. First, several commenters argue, the order seeks to impose a refund condition that is beyond FERC's authority. Second, they object that the conduct subject to the refund obligation is too vaguely defined and the refund obligation too open-ended, putting suppliers at unreasonable risk. Third, commenters object that, even if the Commission has authority to impose the refund condition, it has failed to make the requisite findings under Section 206 that existing market-based rate tariffs are unjust and unreasonable. These comments are discussed in turn below.

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[1] *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 97 FERC ¶ 61,220 (2001). The November 20 Order did not establish an intervention date, but instead has treated this docket as a notice and comment proceeding. In the event intervention is nonetheless needed to secure party status, Michigan hereby gives notice of its intervenor status pursuant to Rule 214.

I. The Refund Obligation Does Not Exceed FERC's Authority.

The Commission, several commenters protest, cannot impose a refund obligation under Section 206 that extends beyond the period between the January 26, 2002 refund effective date and a date 15 months thereafter.[2] The gist of their argument is this: Section 206 provides FERC with only limited refund authority. It can establish a complaint proceeding and make the outcome subject to refund, but the "refund effective date" can commence no earlier than 60 days after the complaint is filed and the refund exposure can last no more than 15 months. Putting sellers at risk for refunds beyond that period exceeds FERC's statutory authority. The short answer to this argument is that it misconstrues the nature of the action the Commission has taken, confusing *initiation* of a 206 rate investigation with a Section 206 *remedy* changing the filed rate.

To be sure, if the Commission were conducting a Section 206 investigation into whether a utility's existing rates were just and reasonable, it could not order refunds of any charges it later found to be excessive beyond the refund authority outlined in Section 206 itself. That, however, is not what FERC has done in this proceeding. Rather, it has concluded that market-based rates – *formula* rates for purposes of the filed rate doctrine[3] -- are no longer reasonable unless the tariff specifies that the seller cannot engage in withholding or collusion.[4] The revised tariff language prohibiting withholding or collusion is effective as of January 26, 2002[5] and

[2] *See, e.g.* Comments of Calpine Energy Services at 2 (cross-referencing its rehearing application at 6); Comments of Independent Energy Producers Association (IEP) at 2; Comments of American Electric Power Service Corp. at 5; Comments of Entergy Corp. at 8; Comments of Mirant Companies at 9-19.
[3] *See Transwestern Pipeline Co.* v. *FERC*, 897 F.2d 570, 577-79 (D.C. Cir. 1990).
[4] November 20 Order at 61,976.
[5] The Commission's November 20 order establishes a refund effective date of January 26, 2002 and proposes to revise all existing market-based rate tariffs and authorizations "to condition all public utility sellers' market-based rate authority to ensure that such rates remain just and reasonable and do not become unjust or unreasonable as a result of anticompetitive behavior or abuse of market power."

constitutes the new, just and reasonable filed rate.[6] As long as that holding is found to be sustainable,[7] charges that do not comport with the revised tariff language would violate the filed rate. *ISO New England, Inc.*, 90 FERC ¶ 61,141 at 61,425 (2000). *See also NRG Power Marketing, Inc. v. New York Independent System Operator, Inc.*, *Order Denying Complaint*, 91 FERC ¶ 61,346 at 62,166 (2000). Thus, *even in the absence of a refund condition in the tariff*, FERC would be empowered to order the return of charges that resulted from withholding or collusion because such charges would be inconsistent with the filed rate.[8] *Cities and Villages of Albany and Hanover, Ill. et al*., 61 FERC ¶ 61,037 at 61,186 (1992) (citing *North Carolina Electric Membership Corp., et al. v. Carolina Power & Light Co.*, 57 FERC ¶ 61,332 (1991)). In kind, this is indistinguishable from the return or "refund" of imprudently incurred costs passed through a fuel clause that allows only the passthrough of *reasonable* and prudently incurred fuel costs. *See Public Service Co. of New Hampshire ("PSNH")*, 6 FERC ¶ 61,299 (1979).[9] The return of charges inconsistent with the tariff formula is not a Section 206 refund, but the remedy

[6] The California Oversight Board, although supportive of FERC's order, makes the same mistake as the commenters cited in note 1. Comments at 4. The Board maintains that, under the filed rate doctrine, FERC cannot order refunds of cost-based rates that are not subject to refund, but then purports to distinguish cost-based rates from market-based rates, which it says can be adjusted because the "actual rates have not been filed and accepted by the Commission, but rather fluctuate with the market." Oversight Board Comments at 4. That distinction, of course, is unsustainable, as market-based rates, no less than cost-based ones, are filed rates.

[7] Michigan discusses, *infra*, the contention that FERC has not made and cannot make the requisite findings under Section 206 that the existing market-based rate tariffs are unjust and unreasonable.

[8] As the Order itself notes, "[v]iolation of such provision [the revised tariff language] would constitute a violation of a tariff or rate schedule on file under FPA Section 205, and the Commission would have the authority to address promptly potential instances of anticompetitive behavior or exercises of market power through the imposition of refunds or such other remedies as may be appropriate." 97 FERC at 61,976.

[9] Mirant argues that the tariff changes do not establish a "fixed" rate, but "require after-the-fact determinations" that a seller engaged in 'anticompetitive behavior.' Mirant Comments at 12-13. This argument is inconsistent with Mirant's own acknowledgment that, under *Transwestern*, the filed rate may take the form of either a stated rate *or* a formula and that "formula rates were permissible despite the fact that a customer could not know the exact charge for service until the end of the billing period." Mirant Comments at 14 (citing *Transwestern, supra* 897 F.2d at 577-79). Whether a seller has permissibly collected prudently incurred fuel costs in a fuel clause likewise requires an "after-the-fact" determination whether the seller acted in accordance with the rate formula. *See PSNH*, *supra*. In both cases, the filed rate formula itself (the fuel clause or, here, the proposed revision to market-based rate tariffs) is known, has been given an effective date (here January 26, 2002) and defines in advance what is allowed. Thus, Mirant's reliance on *AT&T v. FCC*, 836 F.2d 1386, 1391-94 (D.C. Cir. 1988)(Comments at 18) is entirely

for violation of the filed rate. *Id*; *NRG Power Marketing, Inc. v. New York Independent System Operator, Inc.*, 91 FERC ¶ 61,346 at 62,166 (2000). As Michigan noted in its initial comments, the Commission has stated that it "could not conceive of a reasonable basis" for limiting the period during which violations of the filed rate can be corrected. *Cities and Villages of Albany, supra* at 61,186 (citing *North Carolina Electric Membership Corp., et al. v. Carolina Power & Light Co.*, 57 FERC ¶ 61,332 (1991)).

II. With The Clarifications Michigan Has Suggested, Conduct Prohibited Under FERC's Proposed Tariff Changes Will Be Adequately Defined And Will Not Put Suppliers At Unreasonable Risk.

Arguing that market uncertainty can have undesirable effects on investments in generation, several commenters complain that the definition of anticompetitive behavior under FERC's November 20, 2001 Order is too vague and the refund obligation too open-ended, putting sellers at unreasonable risk.[10] The commenters voice an understandable desire for market certainty. Michigan, too expressed its desire for market certainty and, to that end, asked the Commission to clarify its Order.[11] The opposing commenters, however, voice concerns that are based, Michigan believes, on a misapprehension of the Commission's order. The apprehensions voiced by the various commenters take several forms.

FirstEnergy, for example, makes several comments on the Commission's proposed tariff change that seem more in the nature of clarifications than bona fide objections. Thus, in contesting FERC's definition of the exercise of market power to include the physical or

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misplaced, as that case involved a rule that would have required refunds of charges that were in *conformance* with the filed rate.

[10] *See* Initial Comments of Calpine Energy Services at 4-7; IEP Comments at 3-4; Comments of AEP at 6-7; Comments of Entergy at 7-8; Comments of Mirant Companies at 37-38; Comments of FirstEnergy at 4-5.

[11] "[F]or purposes of market certainty," Michigan stated, "the Commission should clarify that its proposed tariff changes would not result in refunds related to specific consummated market transactions established in accordance with Commission-approved RTO market power mitigation rules in effect during the period(s) the charges were imposed, except where those specific transactions result from collusion, withholding, or other abuses of market power." Michigan Comments at 5.

economic withholding of supplies, FirstEnergy complains that such a definition ignores that (1) energy from hydroelectric projects may be limited by the capacity of the reservoir, (2) generating units due for periodic maintenance may face operating limits, and (3) the output of some units may be limited by weather conditions that disrupt the delivery of fuel. FirstEnergy Comments at 4-5. FirstEnergy adds, moreover, that it is unfair to penalize generators for economic withholding if a unit, still operational, but at risk of damage, is shut down at a time when the market price is above the unit's full incremental cost or if it is shut down at a period of high demand because it did not anticipate that demand at the time of the shut down decision. *Id.* at 5.

These concerns overstate the scope of the Commission's refund obligation. A common sense reading of the order suggests that sellers charged with withholding would have the opportunity to demonstrate that withholding did not occur. Thus, for example, sellers would be permitted to demonstrate that their units were shut down because of low water conditions, operating limits necessitated by good utility practice or fuel supply disruptions. Similarly, it appears a strained reading of the Commission's order to suggest that FERC intended to find prohibited economic withholding in cases where a unit had been shut down to conduct a bona fide investigation of a possible mechanical problem. To the extent sellers like FirstEnergy are nonetheless concerned, Michigan would not object to Commission clarification of its order consistent with the above discussion.

Calpine makes an argument similar to FirstEnergy's. Declaring physical or economic withholding as anticompetitive, it says, is too "simplistic." The withholding "may in fact be a legitimate pricing response to less than perfect market designs or flawed market implementation." Comments at 6. The tariff change, however, only bars anti-competitive withholding. Companies would have the opportunity to demonstrate that their withholding was not anti-competitive but was in fact "a legitimate pricing response." *Id.*

For its part, Mirant argues that if the Commission does adopt a form of refund condition, it should modify the condition (1) to define it more precisely to include only "anti-competitive behavior" as defined under the anti-trust laws. (Mirant Comments at 37), (2) should not apply the conditions to sales in ISO/RTO markets where existing mechanisms prevent anti-competitive behavior and exercises of market power (*id*. at 38), (3) should not attach the conditions to bilateral transactions outside of real-time spot markets and (4) allow refunds only where affected customers make their claims within 60 days. *Id.* These objections, too, misapprehend the nature and purpose of the Order.

Limiting the definition of anticompetitive behavior solely to that which is barred under the antitrust laws misses the point of the order. As several commenters *opposed* to the rule have noted, the antitrust laws bar monopolization and attempted monopolization, they do not bar monopolistic pricing.[12] On the other hand, *the* central purpose of regulation is to prevent monopoly pricing. Market-based rates, as Michigan noted in its initial comments, are not deregulated rates. FERC accordingly has an affirmative duty to prevent market power from being exercised to obtain supra-competitive prices. This, moreover, is consistent with FERC's longstanding position that its duties to protect competition allow it to reach conduct that would not necessarily rise to the level of an antitrust violation. *Connecticut Light and Power Co.*, 9 FERC ¶61,313 at 61,665 (1979); *Connecticut Light and Power Co.*, 8 FERC ¶ 61,187 at 61,653 (1979); *Florida Power & Light Co.*, 8 FERC ¶ 61,121 at 61,449 (1979).

[12] *See, e.g.,* Comments of the Staff of the Bureau of Economics and the Office of the General Counsel of the FTC at p. 3. n. 4.

Mirant's second suggestion, that FERC should not apply the conditions to sales "in those ISO/RTO markets with existing mechanisms to prevent anti-competitive behavior and exercises of market power," (Mirant Comments at 38), presupposes that existing ISOs and RTOs have sufficient mechanisms to prevent anticompetitive behavior. In fact, FERC's own experience shows the opposite to be true. Even in regions where there are existing ISOs with market mitigation authority sellers have been able to exercise their market power, California being a prime example. The sound purpose of FERC's order is to restrain those exercises of market power that might otherwise escape detection by the RTO.

Mirant's further suggestions that FERC should not attach the conditions to bilateral transactions outside of real-time spot markets and should allow refunds only where affected customers make their claims within 60 days are also off the mark. There is no reason why prices under longer term bilateral transactions or exercises of market power that go undetected for 60 days should enjoy a safe harbor. Indeed, if the behavior involves collusion, violators will be rewarded for successfully concealing their actions.

Finally, the Commission should reject arguments like Calpine's that seller refund exposure under the terms of the November 20 Order creates an "unworkable level of regulatory risk." Calpine Comments at 4. There are two reasons.

One, the refund risk is not unmanageable. Utilities and gas pipelines have operated for nearly seven decades under Federal Power Act and Natural Gas Act systems in which their rates have been subject to refund, sometimes for several years. Indeed, vertically integrated utilities have typically faced refund obligations of uncertain magnitude in virtually every Federal Power Act case (and under numerous state regulatory regimes) in which they have sought rate increases, yet have successfully raised capital necessary to build the capacity needed to serve load. By contrast, sellers under market-based rate schedules face refund exposure only where they collude (and would have faced antitrust exposure anyway) or are found to have engaged in withholding.[13]

Two, Calpine's objection ignores the statutory framework. To be sure, a desire for certainty underlies the filed rate doctrine, but the certainty the doctrine protects is the certainty that the filed rate will be charged, not that charged rates will be final. *See Maislin Industries, U.S., Inc. v. Primary Steel, Inc., et al*., 497 U.S. 116 at 127 (1990). *See also, Cities of Anaheim, et al. v. California Independent System Operator Corp.*, 95 FERC ¶ 61,197 at 61, 687 (2001).

III. The Commission Has Ample Basis To Make The Requisite Generic Findings Under Section 206 That Existing Market-Based Rate Tariffs Are Unjust And Unreasonable.

Several commenters argue, correctly, that the Commission cannot make the changes to market-based sales tariffs it proposes without a prior finding under Section 206 that existing tariffs are not just and reasonable.[14] Michigan made the same observation in its own initial comments. *See* NECPUC and Michigan Comments at 5 n.3. Opposing commenters are plainly incorrect, however, in suggesting, as does Mirant, that the Commission cannot take action under Section 206 "without presenting any evidence that *each and every* existing market-based rate schedule and tariff may be unjust and unreasonable."[15] To the contrary, FERC has the power under Section 206 to make *generic* findings to support industrywide tariff changes based on the

[13] Michigan agrees that absent collusion or withholding, if a seller complies with the formula in its rate schedule, its rates should be considered final.

[14] *See, e.g.*, Comments of Entergy at 2-3; Comments of Mirant Companies at 19-21; Comments of IEP at 2-3.
[15] Mirant Comments at 19 (Emphasis added).

"potential for overrecovery."[16] *See, e.g., Wisconsin Gas Co. v. FERC,* 770 F.2d 1144, 1157-8 (D.C. Cir. 1985).[17]

Commenters also advance a more limited argument, i.e., that reference to the experience in California is insufficient to justify an industrywide change to market-based sales tariffs. *See, e.g.*, Entergy Comments at 2-3; AEP Comments at 6 (reference to the California experience does not constitute a reason to base its support changes to market-based rate tariffs in other regions of the country). Michigan agrees that, to support a generic rule change the Commission must make findings of a generic problem. This, however, is not a case of an "industrywide solution for a problem that exists only in isolated pockets." *AGD, supra*, 824 F.2d at 1019 (D.C. Cir. 1987). *See also*, *Williams Natural Gas Co. v. FERC*, 943 F.2d 1320, 1322 (D. C. Cir. 1991). In addition to the documented and extensive market power problems in California, the Commission has found market problems in New England, New York and the PJM Interconnection.[18] It has also made findings that several large utility systems not part of any currently operating ISOs, have market power.[19] Michigan urges the Commission to make the requisite findings of generic market power problems necessary to support its action in this case.

[16] In its November 20 Order, the Commission explained that it needed "to take steps now to minimize the *potential for any such market power abuse* or anticompetitive behavior and thus protect against possible unjust and unreasonable rates." 97 FERC at 61,976. (emphasis added).

[17] *See also,* Id. at 1153 n.8 and *see* Transmission *Access Policy Study Group, et al. v. FERC*, 225 F.3d 667,688 (D.C. Cir.2000), *cert. granted,* 69 U.S.L.W. 3574 (Nos. 00-568 (in part) and 00-809) and *cert. denied, Id.* (No. 01-800) (U.S. February 26, 2001)(FERC "not required to make 'specific findings,' so long as the agency's factual determinations are reasonable"); *Associated Gas Distributors v. FERC,* ("*AGD*") 824 F.2d 981, 1008-09 (D.C. Cir. 1987)(FERC not required to make specific findings or offer empirical proof for all the propositions on which its order depended before promulgating generic rule to eliminate undue discrimination).

[18] *See NRG Power Marketing, Inc. v. New York Independent System Operator, Inc*, 91 FERC ¶ 61,346 (2000); *Maine Public Utilities Commission et. al. v. ISO New England, Inc*., 97 FERC ¶ 61,322(2001) (finding that $6000 charge was unreasonable and would have violated filed rate had rules in effect at the time defined exercise of market power to encompass challenged conduct)

[19] *See AEP Power Marketing, Inc*., 97 FERC ¶ 61,219 (2001).

IV. The Commission Should Reject Calpine's Proposed Alternative Conditions.

In its comments, Calpine proposed several alternative conditions to those contained in FERC's November 20 Order. For the reasons stated below, Michigan urges the Commission to reject these conditions.

First, Calpine proposes that the refund obligation in the modified rate schedule would not apply "with respect to sales and markets that the Commission has certified could be fully competitive with effective market monitoring." Comments, page 9-10. This condition is objectionable if for no other reason than that it does not address the problems caused by collusion, intentionally secret action that can escape detection by even the most vigilant of market monitors. The condition also presupposes that no anticompetitive behavior is possible with the presence of an approved market monitor. Experience also shows this to be an unsupportable assumption.

Second, Calpine would exempt from the refund obligation power supply arrangements of "30 days or more" or "sales pursuant to agreements where the parties explicitly waived refund obligations." Comments at 10. According to Calpine, physical and economic withholding would only exist in the day-of and day-ahead markets. Again, there is no basis for this limitation. If there is market power or collusion, it can be exercised to affect prices of contracts that are more than 30 days in length. Moreover, the waiver of refund obligations between two parties would deprive third parties of refund protection and encourage collusion.

Third, Calpine urges a condition that would limit refunds unless the sale is challenged within 30 days. *Id*. at 10. Michigan has previously pointed out that the filed rate doctrine has no time limit as well as FERC's observation that it "could not conceive of a reasonable basis" to impose one. *See* p. 3, *supra*. The 30-day limit, moreover, would encourage sellers to withhold data from market monitors in order to ensure that unlawful conduct goes undetected and therefore becomes uncorrectable. This is self-evidently counter to the public interest.

Respectfully submitted,

STATE OF MICHIGAN,
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CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of the foregoing document by first class mail upon each party on the official service list compiled by the Secretary in this proceeding.

Dated at Washington, D.C., this 5th day of February, 2002.

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Harvey L. Reiter

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